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IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR APPROVAL OF ITS PLAN FOR STRANDED COST RECOVERY	Docket No. E-01345A-98-0473
IN THE MATTER OF THE FILING OF ARIZONA PUBLIC SERVICE COMPANY OF UNBUNDLED TARIFFS PURSUANT TO A.A.C. R14-2-1061 *ET SEQ.*	Docket No. E-10345A-97-0773
IN THE MATTER OF COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA	Docket No. RE-00000C-94-0165

POST HEARING COMMENTS OF ILLINOVA ENERGY PARTNERS

Illinova Energy Partners ("IEP") hereby submits its Post Hearing Comments concerning the proposed APS settlement.

I.

SUMMARY OF RELEVANT ISSUES FOR ELECTRIC SERVICE PROVIDERS (ESPs)

1. **Unreasonable Retention of Market Power by APS**. The settlement allows APS to retain a stranglehold on power generation in the relevant geographic area, effectively keeping wholesale competition to a minimum and virtually eliminating the opportunity for an ESP to offer a retail discount to a customer.

2. **<u>Lack of Proper Ongoing Regulation of APS</u>**. The settlement allows APS to write their own affiliate transaction rules. It does not provide sufficient guarantees of open access to the transmission grid, and it prohibits the power of the Commission to intervene if the settlement proves unworkable in the future.

3. **<u>Lack of Proper Unbundling of APS Rates</u>**. APS' rates are not sufficiently unbundled between competitive and non-competitive services.

4. **<u>Lack of Workable Method of Calculating a "Shopping Credit" or "Energy Credit"</u>**. The plan put forward in the settlement makes it easy for APS to manipulate the competitive portion of the electric bill. Competitors never know for sure what the cost components of the "Standard Offer" from APS actually are, so customers will never know if an offer is desirable compared to the alternative.

5. **<u>Inappropriate Stranded Cost Recovery</u>**. There are several issues regarding the recovery of stranded costs that benefit APS to the detriment of customers and ESPs.

II.

<u>Discussion</u>

The following is a more detailed discussion of the above shortcomings inherent in the APS settlement proposal, from the perspective of an ESP entering the marketplace. The **overall conclusion is obvious: if these issues cannot be resolved so that new market entrants can make a reasonable return on investment in the Arizona market, none will participate.**

IEP's overall evaluation of the APS settlement is summarized below:

a. Customers receive a small discount;

b. The Commission produces a settlement within the time limits proposed earlier, and the utility lawsuits against the Commission are dropped;

c. APS gets to (i) keep their assets; (ii) obtain full stranded cost recovery; (iii) write their own affiliate transaction rules; (iv) submit to little or no regulation in the future; (v) maintain a stranglehold on the wholesale market; (vi) secure control of the transmission grid with little oversight; (vii) obtain an opportunity to use predatory pricing against ESPs; and (viii) incur absolutely no risk for its future behavior in acquiring power for the captive market.

It should be easy to see why the above groups support the settlement proposal, especially APS. It should also easy to see that if ESP's cannot compete, they will not do business in Arizona. The Commission should not approve a plan for small rate discounts in exchange for a one-sided arena where competition appears in name only. If the Arizona Commission desires a truly competitive marketplace, substantial changes must be made to the settlement proposal.

A. **Market Power of APS**.

1. **Transfer of Generation to Unregulated Affiliate**.

Under the terms of the proposed settlement, APS would transfer generation assets to an unregulated affiliate at "book value" but it fails to describe the process under which the transfer will take place. Also, the "competitive assets" that are proposed to be transferred are not even identified. The settlement then allows the unregulated affiliate to sell power to APS at "market" based rates. Since the new owner of the generation will virtually control the market price during much of the year, particularly in the Phoenix area, the market price will be any price established by the APS unregulated affiliate. If approved, this Commission effectively will leave the APS monopoly in place but will concede the ability to regulate pricing. IEP's experience in California shows that a generator with only 10% of the generating assets can effectively control the market during high demand periods of the year. The APS affiliate, with a huge percentage of the generation can control the market price at will. The settlement has no protection against this outcome, and APS bears no risk or penalty for overpaying for power to its own affiliate

2. **Domination of Transmission Grid**.

Under the proposed settlement, APS will maintain complete control of the transmission grid in its service territory. The Arizona Independent System Administrator (AISA) ostensibly will have an "oversight" function and a mandate to ensure open access to the transmission grid. However, AISA, as presently configured, lacks the authority to implement policy or schedule power, and will most likely have little impact on the day-to-day decisions made by the actual transmission operator (APS). AISA's role will most likely be that of "Monday morning quarterback," endlessly discussing and replaying the actions of the past in preparation for some action at FERC, sometime in the distant future. APS will soon see that there is no real consequence for its actions that limit open access. ESPs and other wholesale market participants will soon see that as well, and will drop out of the market if they are not treated fairly and allowed open access on the same basis as APS. There is a small preview of the future in the present settlement proposal wherein APS continues to withhold several of its transmission lines from the process of assigning "pro-rata" shares to competitors, even though regulation requires them to do so (e.g., the Glen Canyon – Phoenix line). It seems inevitable that APS will withhold and manipulate transmission paths that benefit its own self interest, unless effectively regulated or incented to comply.

The pro-rata sharing method of allocating transmission lines produces another problem for competitors, and another opportunity for APS to wield market power. If new market entrants are serving a small load, they are given a pro rata share of transmission lines throughout APS' territory, not specific to the path needed to get from their generation source to their customer. They may trade with other market participants to gain capacity on the line they need, but if APS holds nearly 100% of the allocation (as they will), what will prevent them from refusing to trade or limiting an ESP's options by simply withholding a decision? It will be easy and tempting for APS to discriminatorily "freeze out" competitors while allowing itself and its unregulated affiliate free reign over the transmission system.

Allowing APS to retain a substantial majority of generation assets in the service territory, complete control over the transmission system, and the ability to form affiliates that are not subject strict affiliate transaction rules virtually hands APS the wholesale and retail marketplaces in a nice package. The result will be sweetheart deals with affiliates, cost shifting to regulated enterprises, restricting access by competitors and, in general, use by APS of its status as the incumbent market provider as it pleases. The settlement as proposed will not promote a competitive market place in either the wholesale or retail arenas. It will provide APS more opportunity with less regulation.

3. **<u>One Year Notice</u>**.

A final market power issue is APS requirement that customers with load in excess of 3MW be required to give one year notice before returning to standard APS service. This requirement is obstructionist and anti-competitive and completely in keeping with APS' approach to the settlement.

B. **<u>Lack of Regulation of APS</u>**.

One of the cornerstones of the settlement proposal is less regulation for APS. The Commission gives up the power to modify provisions of the settlement in the future even though some of the settlement might prove unworkable. The Commission will obligate itself upon approval of the settlement not to take any action that would in any way adversely affect the benefits that APS receives as a result of the settlement even if doing so would be contrary to the public interest. The commission effectively may be forced to turn its back on constituents who may have legitimate complaints or who are adversely impacted by unforeseen events. The prohibition against future regulation by the Commission amid facts that require the Commission's ongoing supervision is plainly unlawful.

By comparison, while the Commission's hands are tied in the future, APS is left free to seek Commission action for approval of rate changes, adjustment clauses, standard offers, etc. The situation presented to APS is the best that one could imagine. It will be assured of a baseline revenue, benefit mix and market position that cannot be changed by the Commission, yet it will be free to try to increase its share at any time. APS assumes no risk for its behavior in the future, and reserves the right to pass all the costs incurred through the Commission to the customers.

Under the settlement, the Commission will also lose the opportunity to restructure the marketplace if, in the future, it realizes that an effective marketplace is not developing in the public interest or that APS is effectively dominating the market and using its market power to restrict customer options. The parties who negotiated the settlement seem to discount ESP claims that there will be no competitive market activity under the terms of the APS settlement. Perhaps they are correct. If they are not, as contended by the new ESPs (those people who will create the competitive market) the Commission gives up the opportunity to "fix" the situation. In IEP's estimation, the Commission would give up too much and receive too little in return if it agrees to leave the agreement in place in the future regardless of the circumstances.

The final area of urgent need for further regulation of APS is in the area of affiliate transaction rules. The Commission at one time adopted a set of affiliate rules to be followed by APS and all other Affected Utilities; a subsequent order eliminated those rules in favor of a "code of conduct" proposal. While that new rule is not yet effective, the proposed APS settlement advances a "just trust us" approach to regulation of the relationship between affiliates and the utilities. This is not a workable plan from the perspective of a new market entrant attempting to compete with incumbent utilities and their affiliates. There should be strict prohibitions about name usage, use of common facilities and funds, transfer of expenses to regulated entities and sharing of information. Especially if the present plan to transfer generation assets to an unregulated affiliate is adopted, the opportunity for a utility, its generating arm and its marketing affiliate to participate in sweetheart transactions and eliminate competitors is present and very tempting.

C. **<u>Insufficient Unbundling of APS Rates</u>**.

There has not been any comprehensive effort to unbundle APS rates between competitive and non-competitive services and no party, including the Commission staff, has provided any independent analysis of the alleged "cost basis" for such rates (or APS' alleged stranded costs). The format of APS' standard offer does not comply with the Commission's instructions to unbundle the rates into 10 components, electricity, transmission, system benefits, etc. APS in its filing has chosen to ignore this instruction as well as the one that requires a "cost of service" basis for each of the components of the rate. APS does not even attempt to assign cost of service to its rates, choosing instead to arbitrarily assign a rate structure carefully crafted to limit competition. In order for consumers to make informed choices the rate structure must be simple and transparent. That is, customers should be able to easily compare the Standard Offer to an offer provided by an ESP and make a decision on which is the most attractive from an economic point of view. APS' convoluted methodology and refusal to unbundle rates makes this simple comparison impossible, even by sophisticated customers. IEP submits that APS understands this concept very well and has purposely made comparison shopping difficult. APS' efforts to thwart competition will most likely work if the Commission adopts this settlement proposal.

Here are suggestions for making APS rates "user friendly" so that customers can make informed decisions.

a. APS' rates must be completely unbundled. They must comply with the commission instruction to publish line item rates for the ten components.

b. APS' must be required to base rates on a cost of service basis, in accordance with commission instruction.

D. **<u>Energy or Shopping Credit</u>**.

APS must establish a realistic and easily understood shopping credit or energy credit that the marketplace can see and understand. The convoluted methodology proposed in the settlement will muddy the water to the point where APS or its affiliate will have the upper hand based on name recognition alone. If customers cannot understand the offering they will most likely stay with the incumbent utility. Although the size of the credit remains in question, both SRP and TEP have produced reasonable shopping credit methodologies that are easily understood (although not consistent with their actual costs). APS should be sent back to the drawing board to design a credit that is simple and not so self serving.

The following items need to be addressed directly in any settlement that intends to foster competition in Arizona's electric market.

a. APS' costs to manage its portfolio and other miscellaneous costs associated with acquiring power must be accounted for and added to its costs in the Standard Offer.

b. Energy imbalance costs must be applied to APS standard offer customers as they are applied to direct access customers.

c. Present APS rate schedules work contrary to the actual price of energy supply, providing insurmountable barriers for Energy Service Providers. The rates must be unbundled to reveal APS' actual charge for energy.

E. **Stranded Cost Recovery**.

The notion that APS' electric generation plants are worth only book value is clearly an unwarranted and incorrect assumption. If the power plants were sold at auction to the highest bidder, the market power of APS would likely be reduced, and if the plants sell at a higher price than book value, stranded costs would be reduced. The opportunity for the Arizona ratepayers to have new purchasers of Arizona generation pay a large portion of stranded costs should be attractive to the Commission and its ratepayers. However, that opportunity is lost in the current settlement proposal. The settlement proposal allows for recovery of alleged stranded costs only from the Arizona consumer - and those costs have not been independently analyzed by any party, including the Commission staff. Handing the plants to the APS generating affiliate at book value, and then collecting stranded costs is not fair to Arizona ratepayers. IEP submits that an auction of the generation facilities should be mandated. It is the one true way to determine the actual value of the facilities and to obtain a baseline for calculating reasonable stranded costs. It may be that there are <u>no</u> generation based stranded costs and an auction is the surest method to answer that important question.

Finally, the APS settlement is ambiguous in talking about the "opportunity" to collect stranded costs. Our reading of the actual settlement seems to guarantee the collection of stranded costs. The Commission will eliminate a great opportunity to affect the behavior of APS by ensuring that all alleged stranded costs will be effectively guaranteed regardless of the circumstances.

Dated: August 5, 1999.

Respectfully submitted,

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